CANADIAN AIRLINE INDUSTRY

CANADIAN AIRLINE INDUSTRY

John Christopher
Science and Technology Division

19 January 1993
Revised 28 September 1994

Library of Parliament
Bibliothèque du Parlement

Research Branch

The Research Branch of the Library of Parliament works exclusively for Parliament, conducting research and providing information for Committees and Members of the Senate and the House of Commons. This service is extended without partisan bias in such forms as Reports, Background Papers and Issue Reviews. Research Officers in the Branch are also available for personal consultation in their respective fields of expertise.

Available in Canada through
your local bookseller
or by mail from
Canada Communication Group -- Publishing
Ottawa, Canada K1A 0S9

Catalogue No. YM32-1/89-2-1994-09E
ISBN 0-660-15853-1

N.B. Any substantive changes in this publication which have been made since the preceding issue are indicated in **bold print.**

CE DOCUMENT EST AUSSI PUBLIÉ EN FRANÇAIS

CANADA
LIBRARY OF PARLIAMENT
BIBLIOTHÈQUE DU PARLEMENT

CANADIAN AIRLINE INDUSTRY

ISSUE DEFINITION

The domestic airline industry in Canada has evolved from being an Air Canada (formerly Trans-Canada Airlines) monopoly to being almost completely deregulated. This came about for two reasons. The first was the growing demand from air carriers during the mid-1970s for less government regulation and more competition. The second was the deregulation of the U.S. domestic airline industry. Since the deregulation of the Canadian airline industry with the proclamation of the new *National Transportation Act, 1987* (1 January 1988), the industry, all over the world, has undergone dramatic changes. In the United States, airlines have gone bankrupt and the number of carriers has been reduced. In Europe, with the advent of economic union, countries are now re-evaluating the traditional government ownership of the airlines and lack of interest in deregulation. The industry has also had to cope with the effects of the Gulf War and the general downturn in the economy.

In Canada, we have seen our two national carriers, Air Canada and Canadian Airlines International (CAIL), consolidate their domestic operations and ally themselves with smaller, "feeder" airlines, thereby further dominating the domestic marketplace. Even so, both airlines have experienced financial difficulties in the past two years as a result of the downturn in the economy, fewer passengers, and their own head-to-head competition on routes with too few clients for them to break even or make a profit.

If our carriers are to survive and prosper in the new global environment, they must address the competitive position of Air Canada and CAIL and their feeder networks, North American and international markets, and various options for restructuring.

BACKGROUND AND ANALYSIS

A. 1979-1984

During the 1970s the economic regulation of the airline industry was progressively relaxed in favour of competition. The *Air Canada Act, 1977*, was intended to remove the special advantages and burdens accruing to the national carrier as an instrument of federal government policy. For example, the government had reserved a significant percentage of the domestic market for Air Canada but at the same time had imposed on the airline the "public duty" of serving remote centres. In the words of the Act, Air Canada now had to operate with "due regard to sound business principles and in particular the contemplation of profit" and be regulated, like other carriers, by the Canadian Transport Commission (CTC); it had previously operated under special arrangements with the government.

Passage of the *Air Canada Act, 1977* was followed by the removal of various restrictions on the transcontinental services provided by the other main carrier, CP Air. There was now head-to-head competition between Canada's two largest scheduled carriers in the most important domestic markets.

In 1978, the United States deregulated its airline industry. The effects of this were increasingly to be felt in Canada in the following years, especially as passengers turned to U.S. carriers to take advantage of lower fares. Canadian carriers pushed for a lessening in economic regulation in order to compete on an equal basis with American carriers, while consumers and consumer groups also called for some relaxation in regulatory control so that they could enjoy the benefits of competition.

Opponents of deregulation were concerned that it might lead to greater concentration of the industry, with the major carriers becoming too powerful for others to be able to compete successfully. This, they contended, would, in the long run, result in less competition and higher air fares. In addition, some felt that safety might be compromised with deregulation; that, in an environment where competition was to be the guiding principle, airlines might cut corners in such areas as maintenance.

From this emerged a "go slow" approach to deregulation. In 1982 a House of Commons Standing Committee on Transport report (*Domestic Air Carrier Policy*), recommended continued regulation but with room for greater competition. On 10 May 1984, the Minister of Transport issued a policy statement liberalizing air transport by allowing carriers to compete on routes anywhere in Canada, rather than being restricted to specific geographic regions as had previously been the case. From this evolutionary process the government moved to formalizing deregulation through legislation.

B. 1985-1988

1. *Freedom to Move*

By 1985, the changes in the legislative framework since 1977 had resulted in *de facto* deregulation. On 15 July 1985, the government released its position paper entitled *Freedom to Move - A Framework for Transportation Reform*, which began the process of formally deregulating the transportation industry, including the air sector, by outlining sweeping changes to the *National Transportation Act, 1967*. For all modes of transportation these changes included more competition, reduced economic regulation and a greater reliance on market forces to achieve more competitive prices and a wider range of services.

With regard to the air sector, the paper stated that entry into any class of domestic commercial air service in Canada would be open to carriers meeting a "fit, willing and able" requirement (i.e., the carrier must have adequate liability insurance coverage, comply with the Department of Transport's safety regulations, and be Canadian). It would no longer be necessary for the carrier to establish that its service was required by "public convenience and necessity."

2. Committee Hearings

In order to receive comments and public input on these new policy proposals, the government, on 17 October 1985, referred *Freedom to Move* for study by the House of Commons Standing Committee on Transport, which, after extensive testimony, reported its findings to the House of Commons on 18 December 1985.

While the Committee agreed with the report's recommendations for deregulating the airline industry, the hearings had raised concern over a number of issues, especially: air services in the north; the role of Air Canada in a deregulated environment; and foreign ownership in the airline industry.

a. Air Services in the North

Most of the evidence concerning air services in the north argued for continued regulation, citing the region's low density routes resulting from the sparse, far-flung population; the necessity to provide satisfactory year-round service; and the higher operating costs incurred in this region because of bad weather and higher heating costs for airport facilities. In the witnesses' view, the system of air services in the north was too fragile and immature to sustain wide-open competition. In light of this, the Committee recommended that northern air services continue to be regulated on the basis of the 1984 policy statement, which had drawn a line of demarcation (at roughly 50-55 degrees), north of which regulation would continue to apply.

b. The Role of Air Canada

On the role of Air Canada in a deregulated environment, the Committee heard a wide diversity of opinions. These ranged from the view that Crown corporations should be used as instruments of public policy to provide adequate levels of service where no services would otherwise exist, to the view that the only way to achieve fair competition in the transportation industry was to privatize Air Canada. It was the Committee's opinion that Air Canada required the "freedom to manage" in order to improve organizational efficiency and meet the new competitive challenge; to this end it recommended that the government consider options for privatizing Air Canada.

c. Foreign Ownership

Freedom to Move did not consider Canadian control of commercial air services except to say that "the acquisition of control by foreign interests of transportation undertakings in Canada will generally be subject to review under the *Investment Canada Act*." This Act provided that transactions involving acquisitions of Canadian businesses with assets of $5 million or more were reviewable and could be disallowed if they were not of net benefit to Canada.

Witnesses before the Committee stated that this issue required further consideration; they pointed out that other major aviation nations severely restricted the degree of foreign ownership of their airline systems -- in the United States, 75% of the equity of a commercial air service must be owned by U.S. citizens.

In light of this, the Committee decided that the best way of achieving special treatment for the airline industry would be to extend the proposal in *Freedom to Move* to give the Governor in Council power "to disallow domestic mergers and acquisitions of control of major federally regulated transportation undertakings with gross assets valued at $20 million or more" to all foreign acquisitions of Canadian air carriers, no matter what the value of their gross assets.

On 18 December 1985, the Committee reported these findings and recommendations to the House of Commons in a report entitled *Freedom to Move: Change, Choice, Challenge*.

3. A New Canadian Airline Policy

On 26 June 1986, the government introduced legislation to establish a new *National Transportation Act* (NTA). The bill dealt with all modes of transportation under federal jurisdiction and was designed to encourage more competition, reduce economic regulation and place a greater reliance on market forces.

The key elements of the new policy as set forth in the legislation were: safety was to be the first priority; the transportation system exists to serve the needs of the shippers and travellers; competition and market forces were to be the prime agents in providing transportation services at the lowest possible cost; economic regulation would be reduced to encourage competition; carriers should, so far as was practicable, bear a fair share of the costs of facilities and services provided at public expense and be compensated for publicly imposed duties; transportation was regarded as a key to regional economic development; and carriers should not create undue obstacles to the mobility of all, including disabled persons.

In addition, the bill allowed for the establishment of a new, smaller National Transportation Agency to replace the CTC. This would be responsible for overseeing the legislation and reporting annually to the Minister of Transportation on the operation of the Act.

The specific sections of the bill dealing with air transportation were consistent with the principles set forth in *Freedom to Move*: less regulation; greater reliance on competition and market forces; and an accessible and not excessively costly or time-consuming regulatory process. The government termed this initiative "re-regulation" rather than "deregulation."

Almost all the Standing Committee's recommendations on air transportation were reflected in the legislation, most notably the retention of a modified form of regulation for the north and remote area of Canada. Specifically, the new legislation called for: a new licence test based on safety and insurance requirements and entitled "fit, willing and able" to replace the "public convenience and necessity" test; the elimination of regulation of most passenger fares and air cargo tariffs; continued regulation of northern and remote services; and federal funding only for maintaining essential services in cases of urgent necessity. The regulation of international air services continued to be based on the results of bilateral air agreements between Canada and other countries.

The Standing Committee on Transportation, after extensive hearings, proposed numerous amendments to the legislation and these were accepted by the government. One of the most significant was in the area of foreign ownership; the government lowered the threshold for domestic or foreign acquisitions from $20 to $10 million. The bill was given Royal Assent on 28 August 1987 and came into effect on 1 January 1988.

C. The Present Situation

As noted previously, there has been *de facto* deregulation in the Canadian airline industry since 1984. The *National Transportation Act, 1987* reflected this reality and placed it on a firm legislative footing. Since that time there have been important developments in the Canadian airline industry, as described below.

1. Consolidation of the Airline Industry

Consolidation and concentration within the airline industry were of some concern during the debate on deregulation. Would the importance of Air Canada and CAIL in the Canadian market create a duopoly into which other carriers would not be able to break? Since deregulation, through a series of mergers and acquisitions, Air Canada and CAIL have acquired

regional and feeder airlines through which they provide extensive route networks. They have come to dominate the domestic airline market.

Under the provisions of the *National Transportation Act, 1987*, the National Transportation Agency has the power to review any acquisition of Canadian transportation companies to which it receives an objection and to disallow any proposed acquisition that it deems to be against the public interest. In addition, the Competition Bureau guards against anti-competitive practices through the *Competition Act*.

CAIL was developed through the merging of a major carrier, CP Air, with regional carriers, Eastern Provincial Airways, Nordair and Pacific Western Airways (PWA), in 1987. PWA Corporation is the holding company for CAIL. In 1989 PWA Corporation announced its intention to acquire the shares of Wardair (the only major carrier attempting to compete with Air Canada and CAIL) at a cost of $250 million. After consideration by the Competition Bureau and the National Transportation Agency, the acquisition was allowed. This was the final step in consolidating the industry into two major carriers with their affiliated companies.

Also in 1989 the recession cut demand and the Gulf war raised oil prices, squeezing the revenues of the two major carriers. Faced with overcapacity, they were forced to reorganize service, lay off employees and offer widespread discount fares. This forced acceleration of the transfer of service to regional affiliates on most low density routes. Regional affiliates increased their share of seats from 26% in 1988 to 36% in 1991. Whether or not this trend will continue is difficult to predict; the fate of the affiliates is closely linked to the viability of the major partners.

2. Privatization of Air Canada

As was noted earlier, the Standing Committee on Transport, in its study of the *National Transportation Act, 1987*, recommended that the government explore options for privatizing Air Canada so that it could better manage its affairs. On 12 April 1988, the government announced its intention to issue Air Canada shares to the public. This would allow Air Canada to compete more effectively in the new deregulated environment; as a Crown corporation it had been limited by the terms of the *Financial Administration Act*, under which

Crown corporations are required to seek government approval for corporate and financial plans, a lengthy process that could prevent the carrier from responding quickly in a highly competitive environment. Privatization would also allow Air Canada direct access to equity markets for capital to finance major fleet renewal programs and would place all airlines in Canada on an equal footing. For these reasons, the airline was privatized in October 1988, with 45% of its shares sold to the public. The remainder of the shares were sold in July 1989.

3. Proposed Air Canada-Canadian Airlines Merger

Beginning in 1989, airlines, not only in Canada but throughout the world, were operating in a difficult economic environment. The Canadian industry was faced with a recession, high fuel prices and high taxation levels. Added to this were a reduction in traffic levels and the heavy debt incurred to purchase new equipment. In February, Air Canada announced a $454 million loss for 1992 while CAIL reported a $543 million loss for the same period. This resulted in talk of merging the two to reduce overcapacity and bring some form of rationalization to the industry.

Within this atmosphere, in 1992, CAIL unsuccessfully attempted to forge an alliance, with equity participation, with American Airlines. The Canadian company could not provide sufficient cash guarantees for servicing its operating cash flow requirements or its substantial long-term debt, much of which was the result of several acquisitions, including those of CP Air and Wardair.

Air Canada had been proposing a "made in Canada" solution to the problems of the Canadian carriers. This was generally assumed to imply a merger of the two airlines. Once its discussions with American had broken down, Canadian had little choice but to entertain these offers from Air Canada, although it was reluctant to do so.

During the summer of 1992, the two carriers established a joint merger committee, which, on 8 October 1992, set forth a pre-merger agreement to both Boards of Directors for approval. While few details of the proposed agreement were made public, airline analysts speculated that a new holding company would be formed to oversee the operations of both companies. Under the proposal, based on a one-for-one share swap, PWA shareholders would own approximately 40% of the merged company and Air Canada shareholders 60%.

The proposed merger would have required approval by the National Transportation Agency and the Bureau of Competition. This, however, became a moot point when Air Canada announced that the transaction contemplated by the pre-merger agreement was unachievable. Without giving specific reasons, the boards of both companies had rejected the proposed operating and financial plan. Concerns had been expressed about how a merged entity would be able to function under one holding company with two operating subsidiaries. Another area of contention had been how to cope with a combined debt load of $7.7 billion. Some analysts doubted that the merged carrier would have been able to raise more than $1 billion in equity without government intervention.

As a result of the failed merger, PWA (on behalf of CAIL) resumed talks with American Airlines. As in previous negotiations with American, the key to an alliance was a stronger financial structure for CAIL. To attain this, the government was asked for loan guarantees totalling approximately $190 million in order to secure $500 million in new equity from its employees, American Airlines and a public share offering. On 24 November 1992, the federal government announced that it was prepared to offer only a $50-million loan, and suggested that other parties, including the provinces, PWA's creditors and its employees, might have to make further sacrifices to keep the airline alive. It should be noted that this loan guarantee went against the November 1992 recommendation of the Royal Commission on National Passenger Transportation, which called for "governments to abstain from making any financial contribution that is intended to ensure the survival of an air carrier."

PWA continued to negotiate with American over the next few weeks and at the same time worked to restructure its debt load with creditors. As part of this financial restructuring, PWA temporarily ceased payments to its creditors as of 29 November 1992.

On 29 December 1992, American Airlines signed a conditional agreement with CAIL to invest $246 million in the carrier in exchange for 25% of its voting stock, two seats on the eight-member board of directors and a 20-year computer reservation services contract. American attached four significant conditions to the deal. PWA would have to: convince its creditors to swap $900 million in debt for common shares; win approval from unionized employees for wage give-backs (an average of 10%) and a three-year wage freeze; divest itself of contractual obligations to the Gemini computer reservation system it shared with Air Canada

and move its internal reservation system to American's Sabre division; and gain regulatory approvals from the federal government for foreign investment in a Canadian airline. It agreed to meet these conditions by 31 December 1993.

At the same time as CAIL was negotiating with American, Air Canada was concluding a partnership agreement with Continental Airlines in the United States. Under the terms of that agreement, finalized in April 1993, Air Canada received a 25% voting interest in Continental in exchange for buying $235 million of the airline's notes and stock. With 42,000 employees, Continental is more than twice the size of Air Canada.

A year later, in April 1994, CAIL and American reached an agreement, the conditions to the provisional agreement having been met. American's pilots wanted the deal blocked, fearing loss of jobs if Canadian were flying south of the border, but a U.S. arbitrator denied their complaint. American paid $246 million to acquire one third of Canadian Airlines, thereby acquiring 25% of the Calgary-based airline's voting shares plus representation on its board of directors. In return, Canadian agreed to pay AMR $115 million (U.S.) a year for 20 years in return for use of AMR's technological services, including accounting and reservations.

While these alliances provide benefits to the consumer and maintain competition in the Canadian airline industry, they could have some disadvantages. These include the possible elimination of jobs through consolidation of services, "bleeding" of passengers to the U.S. partners from the Canadian, whose economic position would therefore be weakened, and a deterioration in service (for example, travellers on a Toronto-Vancouver flight might first have to land in a U.S. hub such as Chicago).

The present situation in the Canadian airline industry is still one of change and uncertainty. Is there enough traffic for two carriers? Will the U.S. partners eventually take effective control of our airlines? In addition to this the Minister of Transport has stated that he is concerned about the excess capacity in the Canadian airline industry and has warned that unless it acts responsibly (i.e., reduces capacity and rationalizes services in order to cut costs and increase efficiency) the government may be forced to "recalibrate" the industry. It is still too early to tell how the alliances will finally perform but careful evaluation by the

government will likely have to continue to ensure that we maintain a competitive and viable airline industry.

4. Open Skies Negotiations with the United States

Canada-U.S. transborder air services are governed by a series of bilateral agreements, the first of which was signed in 1949. Since that time, there have been a number of new agreements covering both passenger and cargo services. In April 1991, in response to pressure from both countries for expanded, more competitive transborder air services, Canada and the United States began negotiating a new bilateral air agreement. One of Canada's major priorities is to obtain a phased-in period for new transborder services whereby our airlines would be able to operate on certain routes between major Canadian centres (Vancouver, Toronto and Montreal) and American points for a so-far unspecified period before any American carrier could serve these routes. The Canadians want a longer transition period while the Americans favour a shorter one. Another priority is to obtain guaranteed access (including favourable slots and gates) to major U.S. hubs such as New York and Chicago. Because almost all American airports are controlled and operated by local authorities, the American government is arguing that it cannot impose guaranteed access. Finally, the Canadians would like to have a dispute settlement mechanism in place with a panel for resolving air transport disputes between the two countries, similar to that used in the free trade agreement. At present no agreement has been reached but it is expected that negotiations will resume with the new administration in Washington.

5. Foreign Ownership

The 25% foreign ownership limit for Canadian airlines was included in the *National Transportation Act, 1987* largely because this was the U.S. limit. In this era where globalization of air services is leading to the creation of a small number of world class and worldwide mega-carriers, the level of foreign ownership may become an important policy issue. Foreign mega-carriers wishing to form partnerships or alliances with Canadian carriers may demand more than 25% of the ownership.

PARLIAMENTARY ACTION

Until the *National Transportation Act, 1987* (NTA) came into force, the airline industry had been closely regulated by the federal government. Some progress had been made towards a more competitive environment during the 1970s with the passage of the *Air Canada Act, 1977* and the government's removal of route restrictions from CP Air in 1979. With the passage of the NTA, the government reduced economic regulation and put greater reliance on market forces to enhance competition and provide more efficient and cost effective transportation services to shippers and travellers.

Since the passage of the NTA, the airline industry has consolidated into two major carriers, while facing a reduction in passengers and higher costs for fuel and heavy taxation. In spite of these difficulties, the Royal Commission on National Passenger Transportation rejected the idea of government assistance to the airline industry. At the end of January 1993, the National Transportation Act Review Commission (established under the *National Transportation Act, 1987*) reported on the effects of the legislation on the transportation industry during the past four years. **It made some general recommendations regarding the airline industry but did not deal specifically with issues (e.g., taxation, financial costs) that are damaging the industry's ability to compete in the global marketplace or with the probable regulatory framework if we had only one major airline in Canada.**

CHRONOLOGY

10 April 1937 - Trans-Canada Airlines (TCA) was created by Act of Parliament on a common-stock basis, with the CNR as the sole shareholder.

1942 - CP air was formed by the amalgamation of 10 local air carriers (mainly bush pilot services) by the CPR.

1958 - The Wheatcroft Report, commissioned by the government, favoured the establishment of competitive transcontinental air services on a limited frequency basis.

24 April 1964 - The Minister of Transport announced that, while the theory of competition was not rejected, TCA's mainline operations should not be harmed by undue competition.

27 March 1967 - CP Air was to be allowed gradually to increase its transcontinental services until it was providing 25% of the total transcontinental capacity by 1970.

19 September 1967 - The Canadian Transport Commission (CTC) was created under the *National Transportation Act*, with an Air Transport Committee to regulate the Airline Industry.

November 1977 - Parliament passed the *Air Canada Act*, which had as its core the financial restructuring of the airline to make it more responsive to the competitive marketplace.

March 1979 - The government removed route restrictions from CP Air and allowed it to compete with Air Canada.

15 August 1981 - The government released a Discussion Paper entitled *Proposed Domestic Air Carrier Policy*.

6 April 1982 - The House Standing Committee on Transport reported its findings on *Domestic Air Carrier Policy* to the House of Commons.

15 July 1985 - The government released its position paper entitled: *Freedom to Move*. This set out policies for transportation deregulation based on increased competition, reduced economic regulation, and greater reliance on market forces.

18 December 1985 - The Standing Committee on Transport, tabled in the House of Commons *Freedom to Move: Change, Choice and Challenge*, which made recommendations for inclusion in the new legislation but basically agreed to the thrust of the *Freedom to Move* policy.

ACCO®

ACCOPRESS™

YELLOW	25070	JAUNE
*BLACK	25071	NOIR*
*BLUE	25072	BLEU*
RL. BLUE	25073	RL. BLEU
*GREY	25074	GRIS*
GREEN	25075	VERT
RUST	25078	ROUILLE
EX RED	25079	ROUGE

ACCO CANADA INC.
WILLOWDALE, ONTARIO

* INDICATES 75% RECYCLED 25% POST-CONSUMER FIBRE

*SIGNIFIE 75 % FIBRES RECYCLÉES, 25 % DÉCHETS DE CONSOMMATION

BALANCE OF PRODUCTS 25% RECYCLED

AUTRES PRODUITS: 25 % FIBRES RECYCLÉES